LEGISLATIVE PROPOSAL (BLS-2006-03): CALIFORNIA GENERAL CORPORATION LAW: SUPERMAJORITY VOTE REQUIREMENT

TO: Larry Doyle, Office of Governmental Affairs

FROM: Jeffrey C. Selman, Vice-Chair, Legislation
Executive Committee, Business Law Section

RE: Proposal to Amend §710 of the Corporations Code

Section Action:

Approved by BLS Executive Committee: April 15, 2005
Approved By Corporations Committee: February 4, 2005
Vote: Unanimous

Section Contacts:

Executive Committee Contact:	**Corporations Committee Contact:**
Jeffrey C. Selman Heller Ehrman White & McAuliffe, LLP 275 Middlefield Road Menlo Park, California 94025 Tel: (650) 324-7196 Fax: (650) 324-6625 Email: jselman@hewm.com	James F. Fotenos Co-Chair, Corporations Committee Greene Radovsky Maloney & Share LLP Four Embarcadero Center, Suite 4000 San Francisco, California 94111 Tel: (415) 248-1501 Fax: (415) 777-4961 jfotenos@grmslaw.com

HISTORY, DIGEST AND PURPOSE

The mission statement of the Corporations Committee (the "Committee") of the Business Law Section provides that it shall study, consider, and take a position on and advocate that position with respect to, among other things, "[n]eeded changes to the California Corporations Code" and other statutory changes "that would promote efficiency or effectiveness in practice. ." The Committee has concluded that amending §710 of the Corporations Code (the "Code") to

eliminate its automatic two-year sunset feature would improve the Corporations Code and promote such efficiency and effectiveness.

History. §710 was added to the Code in 1988. 1988 Stats, Ch 1288. Sponsored by Senator Keene, the bill that became §710 (SB 2001) was endorsed by the Department of Corporations, which explained the bill's purpose as follows:

> "The requirement that any imposition of a supermajority voting requirement be approved by at least the same supermajority will help control the use of supermajority voting requirements. Proponents of this legislation contend that supermajority voting requirements are generally used by insiders to control the acceptance or rejection of mergers and acquisitions, and are not always adopted for the benefit of existing shareholders. This legislation is a reasonable approach to accommodating both the interests of corporate boards and shareholders. It protects shareholders from dilution of their voting rights, without unduly hindering the ability of corporate boards and management to take action in the interest of the corporation."

Existing §710. §710 applies to a California corporation with outstanding shares (of whatever class) held of record by 100 or more persons and that files an amendment to its articles of incorporation or a certificate of determination establishing the rights and preferences of preferred shares that contains a supermajority vote provision. For such corporations making such a filing, §710 does basically three things:

- It prohibits the requirement of a supermajority vote in excess of 66⅔% of the outstanding shares or of the outstanding shares of any class or series;
- It requires that an amendment to the articles or a certificate of determination providing for a supermajority vote be approved by the same percentage of the outstanding shares as is required by the provision for the approval of any specified corporate action or actions; and
- It provides that any such provision automatically becomes inoperative two years after the filing of the amendment or a certificate of determination adopting it (the "sunset feature").

A supermajority vote may be renewed by the adoption of a further amendment within one year prior to the expiration date or at any time thereafter by the same vote and subject to the other provisions of §710.

A supermajority vote is defined in §710(b) as "a requirement . . . that specified corporate action or actions be approved by a larger proportion of the outstanding shares than a majority, or by a larger proportion of the outstanding shares of a class or series than a majority." At the time of §710's adoption (1988), §2115 of the Code was also amended to include §710 as one of those provisions made applicable to a so called "pseudo foreign corporation" which is covered by §2115.

While the legislative history is unclear, apparently the Legislature considered the sunset feature to be appropriate given the phenomenon SB 2001 was drafted to address, namely, its use by "insiders" to control the acceptance or rejection of mergers and acquisitions.

In 1993, as further amended in 2002, §710 was amended to exempt from its provisions a corporation which files an amendment of its articles or a certificate of determination on or after January 1, 1994, if, at the time of filing, the corporation has --

- Outstanding shares of more than one class or series of stock;
- No class of equity securities registered under §12(b) or §12(g) of the Securities Exchange Act of 1934, as amended; and
- Outstanding securities held of record by fewer than 300 persons (determined as provided by §605 of the Code).

Proposal. The primary purpose of the proposed revision of §710, set forth below, is to eliminate the two-year sunset feature. The proposed revision would also clarify the operation of the exemptive provision adopted in 1993 (and clarified in 2002) by referring to "shares" rather than "securities" in the 300-person test of current §710(a)(3). The proposed revision would not change the requirements of current §710 that a supermajority vote cannot exceed 66⅔% of the outstanding shares; that any such supermajority vote requirement be approved by as large a proportion of the outstanding shares as is required by the proposed amendment or certificate of determination; the substance of the definition of a "supermajority vote"; or, other than as specified above, the exemption from the operation of §710 adopted in 1993 (as modified in 2002).

Reasons for the Proposal. The sunset feature of §710 is an impediment to the raising of venture capital by California corporations. Venture capital investing typically takes the form of an investment in a start-up corporation through the purchase of its preferred stock, of various series (Series A, B, etc.). The preferred shares are convertible into common shares, at a fixed price or by formula, thus enabling the venture capital investors to participate in the success of the start-up as it grows and prospers. Typically, venture capital investors insist upon a supermajority vote of the preferred shareholders for certain corporate actions. A typical requirement is that the holders of two-thirds or more of the preferred shares must consent to the following actions:

- Any repurchase of preferred shares other than pursuant to specified redemption provisions;
- The repurchase of any shares of common stock (except for buybacks under employee benefit and related plans);
- The authorization or issuance of any senior or *pari passu* equity security;
- The corporation's engaging in certain sales and transfers of assets and other corporate reorganizations; and
- Any amendment of the articles of incorporation changing the rights, preferences, or privileges of the preferred shares so as to adversely affect such shares.

See 1 M. Halloran *et al*, Venture Capital & Public Offering Negotiation 6-12—6-13, 8-49—8-52 (3d ed. 2003).

Supermajority voting provisions are negotiated freely between venture capital investors and start-up companies (and their counsel); there is no reason for the Legislature to insert a term (the sunset feature) into these agreements that is not negotiated by the parties. *See also* 1 Marsh's California Corporation Law §5.14[F] (4th ed. 2004) (critiquing the operation of §710 and concluding that it can serve as an impediment to the raising of capital by California corporations).

By inserting a nonnegotiable term (the sunset feature) into venture capital agreements between California corporations and venture capital firms, §710 also discourages subsequent capital infusions by minority investors. A supermajority voting provision can protect a minority investor from being disadvantaged by the majority. By requiring the supermajority voting provision to be periodically renewed by the shareholders, §710 precludes a minority investor from negotiating a crucial protection for its investment. Particularly for companies that falter or may be working their way through a down business cycle, securing capital from minority investors may be critical to survival. The sunset feature of §710 discourages such investments.

California corporations are permitted, by §204(a)(5) of the Code, to include in their articles a requirement for the vote of a larger proportion (or of all) of the shares of any class or series than is otherwise required by the General Corporation Law. There is no reason why this power should be circumscribed by a two-year sunset feature for a certain class of California corporations. Generally, corporations with a large number of shareholders are subject to the SEC's proxy rules. These rules require, for any proposal seeking shareholder approval for a supermajority vote requirement to be included in the corporation's articles of incorporation, extensive information about the proposal, including disclosure of its potential adverse consequences.[a]

§204(a)(5) of the Code, permitting the addition of a supermajority vote requirement in the articles of a California corporation, is expressly qualified by reference to, among others, §303 of the Code. §303 of the Code permits removal of a director without cause, if the removal is approved by the holders of a majority of the outstanding shares, subject to certain restrictions designed to protect the principle of cumulative voting in the election of directors. In short, a California corporation may *not* include in its articles of incorporation any requirement that removal of directors without cause be approved by a greater percentage than is mandated by §303 of the Code. The board of directors of a California corporation may not, therefore, use the mechanism of the supermajority vote to insulate themselves from removal by the shareholders.

Finally, the members of the Committee, who represent a broad range of corporate practice, many from firms with a national practice, are not aware of any comparable statutory provision in another state that imposes a sunset feature on the power of a corporation and its shareholders to negotiate supermajority voting provisions.

[a] See SEC Schedule 14A, Item 19, SEC Rule 14a-101.

II. Application

If adopted, the proposed amendment to §710 would become effective January 1, 2006.

III. Pending Litigation

None to our knowledge.

IV. Likely Support and Opposition

We anticipate that the proposed revision of §710 would receive the strong support of the venture capital community. No opposition is currently expected.

V. Fiscal Impact

None expected.

VI. Germaneness

The subject matter of the proposed revision of §710 is one in which the members of the Business Law Section (and, in particular, the members of the Corporations Committee) have special experience since they prepare and negotiate the terms of venture capital financing documentation and supermajority voting requirements of articles of incorporation and certificates of determination for California corporations. The subject matter requires the special knowledge, training, experience, and technical expertise of the Business Law Section. In addition, the proposed amendment would promote clarity, consistency, and comprehensiveness of the law.

VII. Text of proposal

SECTION 1. Section 710 of the Corporations Code is amended to read:

710. (a) ~~This section applies to~~ *An amendment of the articles of incorporation or a certificate of determination of* a corporation with outstanding shares held of record by 100 or more persons (determined as provided in Section 605) ~~which files an amendment of articles or certificate of determination containing a "supermajority vote" provision on or after January 1, 1989; provided that this~~*that files after January 1, 1989 an amendment of its articles or a certificate of determination that includes a "supermajority vote" requirement shall be approved by at least as large a proportion of the outstanding shares (Section 152) as is required by the amendment of the articles or the certificate of determination for the approval of the corporate action or actions specified in such amendment or certificate of determination. No supermajority vote which is subject to this section shall require a vote in excess of 66 2/3 percent of the outstanding shares or 66 2/3 percent of the outstanding shares of any class or series of those shares.*

(b) A "supermajority vote" is a requirement set forth in the articles or in a certificate of determination authorized under any provision of this division that specifies corporate action or actions be approved by a larger proportion of the outstanding shares than a majority, or by a larger proportion of the outstanding shares of a class or series than a majority.

(c) This section shall not apply to a corporation ~~which~~ *that* files an amendment of *its* articles or *a* certificate of determination on or after January 1, 1994, if, at the time of filing, the corporation has (1) outstanding shares of more than one class or series of stock~~;~~, (2) no class of equity securities registered under Section 12(b) or 12(g) of the Securities Exchange Act of ~~1934;~~ *1934,* and (3) outstanding ~~securities~~ *shares* held of record by fewer than 300 persons determined as provided by Section 605.

~~(b) A "supermajority vote" is a requirement set forth in the articles or in a certificate of determination authorized under any provision of this division that specified corporate action or actions be approved by a larger proportion of the outstanding shares than a majority, or by a larger proportion of the outstanding shares of a class or series than a majority, but no supermajority vote which is subject to this section shall require a vote in excess of 66 2/3 percent of the outstanding shares or 66 2/3 percent of the outstanding shares of any class or series of those shares.~~

~~(c) An amendment of the articles or a certificate of determination that includes a supermajority vote requirement shall be approved by at least as large a proportion of the outstanding shares (Section 152) as is required pursuant to that amendment or certificate of determination for the approval of the specified corporate action or actions. The supermajority vote requirement shall cease to be effective two years after the filing of the most recent filing of the amendment or certificate of determination to adopt or readopt the supermajority vote requirement. At any time within one year before the applicable expiration date, a supermajority vote requirement may be renewed, and at any time after the expiration date, a supermajority vote requirement may again be made effective for another two year period, by readopting the provision and filing a certificate of amendment pursuant to, and subject to the limitations of, this subdivision. If the provision is not readopted in this manner, then the particular corporate action or actions previously subject to the supermajority vote shall thereafter require a vote of only a majority of either the outstanding shares or the shares of the specified class or series which had previously been subject to the supermajority vote provision, whichever the case may be.~~

(d) The amendments made to this section by the act amending this section in the 2001-02 Regular Session shall not affect the rights of minority shareholders existing under law.

Membership in the BUSINESS LAW SECTION is voluntary and funding for section activities, including all legislative activities, is obtained entirely from voluntary sources.